



Trade Facts

Critical Assessment of Department of Treasury China Currency efforts
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Department of Treasury Efforts Not Yielding Results on China Currency

"With steady progress clearly being made, the most effective way at this time to achieve the goal of a flexible, market-based exchange rate in China is to maintain the persistent engagement we have established rather than through a trade petition." Treasury Secretary John Snow, April 28, 2004

"Ohio Republican [Sen. George Voinovich] complained on the Senate floor that, despite his protests, the Bush administration has yet to 'take any significant action' against China for currency manipulation and counterfeiting American goods, which rob Ohio factories of thousands of jobs. 'The state of enforcement is nothing short of abysmal,' Voinovich said." Cleveland Plain Dealer, July 16, 2004

Overview

Treasury Claim: The progress China is making toward a more flexible, market-based exchange rate demonstrates that the Administration's engagement with China is yielding results. Secretary Snow, other senior Treasury officials, and Secretary Snow's special emissary to Beijing on exchange rate issues, have held extensive and substantive consultations with China's economic leaders on currency-related issues. Treasury's technical cooperation program is recognized by both our governments as a valuable dialogue on financial sector and exchange rate matters. Given the progress to date, this intense and broad-ranging engagement is the most effective way of achieving the goal of moving China to a more flexible, market-based exchange rate regime.

REALITY CHECK: Where is the "progress to date" and the "results"? More "consultations" and "technical cooperation" just give China a continuing free pass to take its time. For years, China has been promising to reform its exchange rate policy, and for years it has kept the exact same peg – there has been no progress. Secretary Snow stated a year ago about the U.S. trade deficit with China "We would like to see that trade deficit narrow ... I think it's unsustainably large at current levels." [World News Connection, 9/3/03]. A year later, the U.S. trade deficit with China is on pace to widen by over \$30 billion to a new record high. While Treasury continues to pursue long-term goals for improving China's economy and financial system, Chinese exporters gain a massive exchange rate subsidy and continue to drive American companies out of business.

Treasury has argued that more aggressive efforts to obtain revaluation would interfere with China's efforts to deal with its already overheated economy. But, the opposite is true. China's undervalued currency is contributing to its overheated economy and China's refusal to address its undervalued currency is hurting its efforts to place rational brakes on its internal growth. Further, were China to address its undervalued currency as a means of cooling its economy, it would reduce the need for increased state control of the economy.

Capital Account Liberalization

- In August 2004, China permitted domestic insurance companies to invest up to 80 percent of their current foreign currency holdings in overseas debt and money markets, effective immediately.
- In July 2004, China announced it would allow its national social security fund to invest in overseas capital markets.
- In 2003, China announced policies to encourage foreign direct investment (FDI) outflows including decentralization of approval authority for outward FDI and streamlining regulation for FDI approval.
- In 2003, the limit was raised on foreign currency allowed to Chinese travelers and declaration procedures were simplified.

REALITY CHECK: *Economist Intelligence Unit, September 13, 2004: "China is not expected to move to convertibility on the capital account in the near future." That Treasury is forced to trumpet small steps involving minor subsets of China's economy (e.g., foreign currency for Chinese tourists) illustrates the basic flaw in Treasury's approach. These are minor, incremental steps. None of them – however beneficial for China's own economy – has had any impact on China's undervalued currency. It is still pegged at the same rate to the dollar that it has been for the past ten years. None of them signals a real possibility of capital account liberalization any time soon. Perhaps because Treasury is willing to accept a go slow approach, Secretary Snow refused to pressure China for a timetable, "I don't think it's helpful for us to try and talk about a timetable." [AFX News Ltd., 9/3/03]*

Financial Sector Reform

- The banking regulator has adopted a new supervisory strategy. Though implementation is in the early stages, new guidelines outline a comprehensive, risk-based approach that emphasizes adequate governance and internal controls at banks.
- The regulator announced new capital adequacy rules and new five-category loan classification guidelines for commercial banks that are more in line with international best practices. While full implementation is required by 2007, some banks are reporting financial data based on these standards now.
- The government has taken actions to restructure two of the largest state-owned commercial banks. In March, the authorities formulated guidelines on corporate governance for the two banks, which include assessing managers' performance based on their attainment of financial benchmarks.
- In December 2003, China's central bank gave banks greater leeway in determining lending rates.

REALITY CHECK: *The very limited nature of Treasury's supposed "highlights" of reform – "supervisory strategy," "more in line" with best practices, "greater leeway" – demonstrates that Treasury does not understand the urgency of the problem facing America's manufacturers. The Treasury approach does nothing to address China's undervalued currency in the foreseeable future. Treasury's focus is on a long-term (5 or 10 year) effort to bring about structural reform to China's financial system that may in turn lead to China being able to float its currency. By the time Treasury reaches its goal, thousands of additional American businesses will have closed their doors and tens of thousands or more will have lost their jobs due to China's currency manipulation practices. Treasury may have time to wait until 2007, for China to fully implement limited banking reforms; American businesses and workers don't.*

Foreign Exchange Market and Financial Product Development

- In August 2004, The Shanghai Futures Exchange (SFE) announced it will cooperate with NYMEX (New York Mercantile Exchange) on physical delivery futures contracts, clearing procedures and risk management (including comprehensive training). Fuel oil futures will be initiated by SFE. This step will help deepen knowledge of derivatives instruments in general and how to trade, process and clear these types of financial transactions in China.

REALITY CHECK: This has nothing to do with the value of China's currency in the short-term.

- In June 2004, China's foreign exchange operational center in Shanghai announced it would collaborate with the Chicago Mercantile Exchange to develop new products to hedge foreign exchange risk using derivatives (such as futures and forward contracts).

REALITY CHECK: One type of foreign exchange risk that Chinese exporters need not hedge against is appreciation of the yuan versus the U.S. dollar – it's still a government-fixed exchange rate as it has been the past ten years.

- In November 2003, China announced plans to allow renminbi trading and deposits in Hong Kong.

REALITY CHECK: China actually announced its intent to pursue this policy in July 2003, it just took it six months to actually begin implementing it ["Hong Kong Bankers seeking more details on yuan business," AFX-Asia, July 29, 2003]. Even as implemented, the reform is minor: "Because of China's strict currency controls, Hong Kong banks cannot handle contracts in renminbi. ... In Hong Kong, banks are not allowed to handle corporate renminbi business. On the mainland, Hong Kong banks cannot lend to individuals in the Chinese currency. 'They are crossing a river by touching each stone,' said Andrew Look, head of Hong Kong research at UBS." ["HK seeks wider China role for its banks," Financial Times, 9/21/04] "Continuing restrictions on Renminbi business also weigh heavily on Hong Kong banks." [Asian Banker Journal, 9/15/04]

Financial Services Opening

- In September 2004, China will streamline the application process for foreign banks regarding new entry or expansion of business, and incorporate prudential rule changes to ensure national treatment.

REALITY CHECK: A recent China Business Review article notes, "Foreign bankers in China have faced many of the same problems plaguing foreign insurers: high capitalization requirements, lengthy licensing processes, and limitations on business scope."

- Effective August 2004, China permits GMAC and its Chinese partner's joint venture to start operations to extend auto-loans. Ford Motor's financial unit also was approved to setup operations.

REALITY CHECK: This has nothing to do with and will have no impact on China's undervalued currency.

- Over the past year, China has lowered capital requirements for bank branches. In September 2004, China will permit foreign banks to open multiple bank branches a year (rather than just one).

REALITY CHECK: The Asian Banker Journal reports "But, in all honesty, it is unlikely that even a reduction as large as RMB 100 million [in the capital requirements, from 600 million RMB to 500 million RMB] will have a significant impact on expansion decisions. ... However, it remains to be seen whether [certain reforms] will significantly speed up new branch openings, given that the capital requirement of RMB 500 million per branch remains in place." [Asian Banker Journal, 9/15/04]

- In December 2003, China's bank regulator announced modest measures to allow foreign banks more local currency business and larger stakes in joint venture banks.

REALITY CHECK: Once again, the "modest" nature of this highlight demonstrates that Treasury is focused on a 5-10 year time frame. Even presuming the Bush Administration is correct in its go-slow strategy, none of the steps touted by Treasury reflects the systemic change to its financial system of the kind needed to allow China to float its currency.

Current Account Reform

China is taking steps to increase the amount of foreign exchange earnings firms can retain and to reduce export tax subsidies. Concrete efforts to reduce strong upward pressure on China's balance of payments will facilitate a move toward a more flexible exchange rate.

- In January 2004, China approved plans to reform its export tax rebate system by adjusting rebate rates on certain exports. This step helps to reduce the tax incentives to exporters.

REALITY CHECK: The Treasury Department is touting reduced export tax subsidies, when it should be focused on eliminating export subsidies outright. The first and largest export subsidy that needs to be eliminated is the 15-40% subsidy for all Chinese exporters from China's undervalued currency.